Office of Chief Counsel
Internal Revenue Service

memorandum

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HNAdams

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From FOIA Disclosure

date: March 14, 2000

to: District Director, Brooklyn
Chief, Quality Measurement Section

from: District Counsel, Brooklyn

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subject: **Request for Opinion**
[redacted]
EIN [redacted]
Tax Year: [redacted]
Statute Expiration Date: [redacted]

U.I.L. No. 163.03-02

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Reference is made to your February 7, 2000 request for advice regarding the above taxpayer.

SUMMARY OF THE FACTS

[redacted] loaned its shareholders $[redacted] during [redacted] and reported that the shareholders paid interest on the loan during [redacted].

ISSUE

Does interest paid on the loan qualify as investment interest?

CONCLUSION

Whether interest paid on the loan constitutes investment interest depends on whether the indebtedness is properly allocable

to property the shareholders held for investment. I.R.C. § 163(d)(3). Indebtedness is properly allocable to property held for investment if the shareholders used the loan proceeds for an investment expenditure. Temp. Treas. Reg. § 1.163-8T(a)(4)(i)(C). An investment expenditure is "an expenditure (other than a passive activity expenditure) properly changeable to a capital account with respect to property held for investment (within the meaning of section 163(d)(5)(A)) or an expenditure in connection with the holding of such property." Temp. Treas. Reg. § 1.163-8T(b)(3).

DISCUSSION

Our understanding of the facts, which is based on the January 21, 2000 memorandum from the manager of Examination Group 1045, the materials submitted therewith, and a March 7, 2000 conversation with Revenue Agent Albert Harrison, is as follows.

[redacted] is an accrual basis S corporation with a December 31 taxable year end. It had [redacted] shareholders during [redacted], and was accordingly subject to the consolidated audit and litigation provisions provided by former Code sections 6241 through 6245.[1]

In [redacted], [redacted] loaned its shareholders $[redacted] at a stated interest rate of [redacted]%. As of [redacted], the shareholders had paid no interest on the loan, and [redacted] had reported no interest income from the loan.[2]

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[1] The TEFRA procedures provided by Code section 6241 through 6245 applied to S corporation years for which returns were due on or after January 30, 1987 unless the S corporations had 5 or fewer shareholders, each of which was a natural person or an estate. Temp. Treas. Reg. § 301.6241-1T. Although section 1307 of the Small Business Job Protection Act of 1996 repealed Code sections 6241 through 6245, the repeal was effective only for tax years beginning after December 31, 1996.

[2] [redacted]'s failure to report interest income on the loan is inconsistent with the accrual method of accounting. As an accrual basis taxpayer, [redacted] should have accounted for interest that accrued on the loan by including the interest in income each year as it accrued. Treas. Reg. § 1.451-1(a). However, [redacted] had adopted the cash method of accounting for the income by erroneously using the

[redacted] apparently simply added the interest that accrued each year to the balance owed by its shareholders. For example, [redacted]'s [redacted] U.S. income tax return for an S corporation, which was received by the Service on [redacted], reflected beginning of year loans to shareholders of $[redacted] and end of year loans to shareholders of $[redacted]. The end of year loan amount of $[redacted] is exactly $[redacted] more than the beginning of year amount of $[redacted]. The $[redacted] increase is exactly [redacted]% of $[redacted]. However, [redacted] reported no interest income on its [redacted] U.S. income tax return.

[redacted] reported on a Schedule K-1 attached to its [redacted] return that [redacted] owned [redacted]% of its stock. On their [redacted] joint income tax return, [redacted] and his wife reported their distributive shares of [redacted]'s ordinary income and section 179 expense deduction from the Schedule K-1.

Thereafter, [redacted] filed an amended [redacted] income tax return. The amended return, which was received by the Service on [redacted], included a Form 8082 (Notice of Inconsistent Treatment or Amended Return) reporting that $[redacted] of interest income from shareholder loans and $[redacted] of distributions to shareholders had been omitted from the original return. The omitted distributions to shareholders represented a decrease in loans to shareholders from $[redacted] to $[redacted]. [redacted]'s representative explained in a [redacted] letter that [redacted] treated the $[redacted] reduction in loans to shareholders as a distribution to the shareholders of that amount. He explained that as the amount of the distributions to shareholders was less than [redacted]'s accumulated adjustments account, the shareholders were not required to include the distribution in gross income. See I.R.C. § 1368(c)(1).

The [redacted] also filed an amended return for [redacted]. On the amended return, the [redacted] reported an additional $[redacted] of

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cash method of accounting for the income on more than one consecutive return during the years before [redacted]. See Rev. Rul 1990-38, 1990-1 C.B. 57. Having adopted the cash method of accounting for the interest income, [redacted] is required to obtain the Service's permission before changing to the accrual method. I.R.C. § 446(e).

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gross income ([redacted]% of $[redacted]) and an additional $[redacted] of itemized deductions. The return explained that the increase in adjusted gross income was [redacted]'s distributive share of the $[redacted] of interest income from [redacted] as had been reported on an amended Schedule K-1, and that the increase in itemized deductions was investment interest expense that the [redacted] had failed to deduct on their original return.

In his [redacted] letter, [redacted]'s representative states that its shareholders had constructively paid [redacted] $[redacted] of accrued interest during [redacted] by foregoing distributions of that amount. As a result, the representative states that the interest constructively paid by the shareholders should be included in [redacted]'s taxable income and deducted by its shareholders.

In a [redacted] response, the manager of examination Group 1409 responded that the shareholders are not entitled to deduct the amounts claimed as interest paid to [redacted] as qualified investment interest. The response explains that investment interest is interest paid or accrued on indebtedness properly allocable to property held for investment, that "a loan to shareholders is not property held for investment," and that investment interest does not include interest on funds borrowed in connection with a trade or business.

If the shareholders could be considered to have paid $[redacted] of interest to [redacted] in [redacted], whether the interest constitutes investment interest depends on whether the indebtedness is properly allocable to property the shareholders held for investment.[3] I.R.C. § 163(d)(3). Indebtedness is properly

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[3] We question whether the shareholders can be considered to have paid interest during [redacted]. The taxpayer's representative relies on I.T. 1666, II-1 C.B. 64 (1923) for the proposition that the taxpayers should be considered to have constructively paid interest to [redacted]. That document, which is an article under the Revenue Act of 1921, addressed the tax consequences that resulted when shareholders pledged stock of a corporation as security for a loan from the corporation and agreed to forgo dividends on the stock in lieu of paying interest on the loan. It concluded that the shareholders had constructively received the foregone dividends (which they were required to include in income) and had constructively paid

allocable to property held for investment if the shareholders used the loan proceeds for an investment expenditure. Temp. Treas. Reg. § 1.163-8T(a)(4)(i)(C). An investment expenditure is "an expenditure (other than a passive activity expenditure) properly changeable to a capital account with respect to property held for investment (within the meaning of section 163(d)(5)(A)) or an expenditure in connection with the holding of such property." Temp. Treas. Reg. § 1.163-8T(b)(3). Whether interest would constitute investment interest depends on whether the proceeds of the debt to which the interest relates is traceable to an investment expenditure. Temp. Treas. Reg. §§ 1.163-8T(a)(3) and 1.163-8T(a)(4)(i)(C). In other words, whether interest paid by the shareholders constitutes investment interest depends on how the shareholders used the $[redacted] that they borrowed from [redacted]. Although the material provided does not indicate how the shareholders used the loan proceeds, Revenue Agent Harrison stated during a [redacted] telephone conversation that the taxpayer's representative asserts the shareholders invested the money in another company. Revenue Agent Harrison stated that the representative has not substantiated that claim, however. As the issue of whether the interest constitutes investment interest depends on how the shareholders used the loan proceeds, if the shareholders fail to substantiate that the indebtedness is properly allocable to property they held for investment after they are asked to provide such substantiation, then it would be reasonable to take

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interest equal to the foregone dividends.

We agree with the examination division's [redacted] response that the situation in this case is factually distinguishable from the circumstances addressed in I.T. 1666. The most obvious factual distinction is that there is no evidence that [redacted]'s shareholders have agreed to give up any distributions (dividends or otherwise) from that corporation in lieu of paying the interest that had accrued on the amount the corporation carried as a loan to shareholders. In the circumstances, we agree with the conclusion expressed in the examination division's [redacted] response to the taxpayer's representative that the shareholders cannot be considered to have paid interest to [redacted] by foregoing a distribution from it. Whether [redacted] received interest income from its shareholders in [redacted] is an S corporation item. See Temp. Treas. Reg. §§ 301.6245-1T(a)(1)(i) and 301.6245-1T(c)(2)(ii) and (iii).

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the position that any interest they paid on the loan from [redacted] does not qualify as investment interest.[4]

This opinion is based on the facts set forth herein. It might change if the facts are determined to be incorrect or if additional facts are developed. If the facts are determined to be incorrect or if additional facts are developed, this opinion should not be relied upon. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions, you should call Halvor Adams at (516) 688-1737.

DONALD SCHWARTZ
District Counsel

By: _____
JODY TANCER
Assistant District Counsel

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[4] Whether interest paid by shareholders on the loan constitutes investment interest is not an Subchapter S item as it is not among the items more appropriately determined at the corporate level than at the shareholder level. Temp. Treas. Reg. § 301.6245-1T.

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